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C O N F I D E N T I A L SECTION 01 OF 04 TOKYO 000892

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DEPARTMENT FOR EAP/J, EEB
DEPARTMENT PASS USTR FOR CUTLER AND BEEMAN

E.O. 12958: DECL: 03/31/2018
TAGS: [PGOV](#) [PREL](#) [EFIN](#) [ECON](#) [MOPS](#) [JA](#)
SUBJECT: GAS TAX, SMA EXPIRE; "APRIL PANIC" OVERBLOWN

REF: A. TOKYO 0860
[1](#)B. TOKYO 0761
[1](#)C. TOKYO 0646

Classified By: Ambassador J. Thomas Schieffer, reasons 1.4(b),(d).

[1](#)1. (C) Summary: March 31 marked the sunset of Japan's decades-old "provisional" gas tax rate, as the opposition parties rejected an eleventh-hour proposal by Prime Minister Fukuda that would have kept the taxes in place but would have made related revenues available for general use starting in FY 2009, rather than keeping them in accounts earmarked for road construction. The ruling coalition has announced its intention to use its two-thirds override power in the Lower House to break the gridlock on or shortly after April 29. Real economic impact is expected to be minimal, assuming the break in tax collections is relatively brief, but the prospect of yo-yoing taxes on a basic commodity could add to impressions that Japan's government is incapable of prudently managing its economic affairs. The two sides did manage to agree on a stopgap measure to extend other revenue items for 60 days, assuring little disruption in the FY2008 budget, passed on February 29. The fight over the gas tax has damaged the public standing of both the ruling LDP and the opposition DPJ, but Fukuda appears to be getting the better of DPJ leader Ozawa in some circles for his willingness to seek genuine reform. Ironically, Fukuda's failure to clear his proposal with construction interests within his own party and coalition partner Komeito could leave him more vulnerable, as he tries to sell the public on restoring the gasoline tax in the weeks ahead. Separately, the SMA governing support for U.S. forces in Japan also expired on March 31. End summary.

Gas Tax Sunsets; Other Taxes Extended 60 Days

[1](#)2. (SBU), Japan's "provisional" gasoline and road-related taxes, dating from 1974, expired on March 31 after the divided Diet failed to reach agreement on legislation to extend the revenue measures. (Legislation to extend the umbrella Special Tax Measures Law that expired March 31 had been passed in the Lower House on February 29, but never

taken up by the Upper House.) The new law would have extended collection of the JPY 25.1/liter tax for another ten years and continued allocating these monies to the central government to hand out for road construction and maintenance projects. If the opposition-controlled Upper House fails to take action by April 29 (just two days after a key national by-election in Yamaguchi Prefecture), the ruling coalition can pass the extension into law by a two-thirds majority re-vote in the Lower House.

¶3. (SBU) The Upper House has yet to begin formal deliberations more than one month after receiving the approved bill from the Lower House. The opposition has refused to deviate from its insistence on eliminating the provisional tax rate on a permanent basis, even after Prime Minister Yasuo Fukuda offered a last-minute compromise that would have agreed to DPJ demands to treat revenue from the provisional gasoline tax as general revenue starting in 2009 (Ref A).

¶4. (SBU) The proposed Special Tax Measures Law revision also includes provisions on over 100 unrelated revenue measures, in addition to the road-related taxes. Recognizing the need to avoid disrupting these less controversial revenue inflows -- Japan's annual budget deficit is about 4.0 percent of GDP -- the ruling and opposition parties cooperated on March 31 to pass a stopgap measure extending the non-road-related tax measures for sixty days, until May 31. Passing the law to extend the Special Tax Measures Law on or after April 29 will serve to extend the non-road-related taxes beyond May 31. If that legislation is modified or fails to pass, however, the non-road-related tax measures will need to be extended again

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via some alternative legislation.

¶5. (SBU) An opposition Democratic Party of Japan (DPJ) counterproposal to the ruling Liberal Democratic Party (LDP)-Komeito coalition's Special Measures Tax Law revision already excludes road-related taxes from the omnibus bill, but has yet to be deliberated, amidst DPJ concerns that passage of its counterproposal could be construed as a rejection of the ruling coalition's bill and thereby allow the Lower House to take an earlier re-vote. The DPJ reportedly conditioned its cooperation on the March 31 stopgap measure on an agreement with the leaders in both Houses that a vote on the non-road-related taxes would not be similarly misconstrued.

Economic Impact Minimal, Dependent on Final Outcome

¶6. (SBU) Japan's consumers awoke April 1 to find generally lower fuel prices available. Significant short-term economic impact, the government is considering measures to offer loan guarantees and interest subsidies to retailers unable to meet operating costs. The DPJ has also floated its own proposal to offer credits to retailers for their potential losses.

¶8. (SBU) There may also be some short-term decrease in government spending. Several prefectural governments have indicated they will place an immediate freeze on some portion of current road construction projects to account for projected revenue shortfalls. The central government has generally preached restraint, and Embassy contacts anticipate that no new bond issues will be necessary to deal with what they expect to be a brief interruption in gas tax revenues. A Nikkei analysis notes little short-term economic impact, although it cites potentially serious economic consequences if the provisional tax were to be eliminated over the longer term and road construction projects had to be cut.

¶9. (C) In fact, should the short-term drop in the provisional tax become a longer-term scenario, the macroeconomic impact will expand. The fiscal impact is potentially large, as the

road-related taxes amount to JPY 2.6 trillion (USD 26 billion) annually. If planned road-improvement projects are implemented by issuing additional bonds, the combined central and local government deficit would rise 0.5 percent of GDP, posing a serious risk to the government's medium-term fiscal consolidation goals. If instead, road construction projects were eliminated, that would withdraw government investment from the economy, lowering the economic growth rate. A sustained drop in gas prices would lower the CPI, potentially by 0.4 percentage points according to market analysts. Lower prices could raise consumption to the extent that consumers spend their windfall on other goods and services. Though the impact would not be very large, if sustained for the whole fiscal year, personal consumption could rise around 0.5%, if the entire windfall is spent.

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¶10. (C) More problematic, however, is the growing sense that the political situation is keeping the government from prudently managing the economy. Following so closely on the government's failure to appoint a Bank of Japan (BOJ) Governor (Ref B), many observers see the expiration of the "provisional" taxes as another sign that nobody is at the economic helm during a time of heightened concern about global markets. Prime Minister Fukuda, for his part, offered a public apology March 31 for the uncertainty and confusion caused by the failure to extend relevant legislation.

Political Fallout More Difficult to Predict

¶11. (C) Media coverage over the past several weeks has been largely critical of Prime Minister Yasuo Fukuda for his failure to display greater leadership in managing the BOJ Governor and budget-related tax issues. Over the past several days, however, the tide has shifted rather suddenly in favor of the government and against the opposition. Recent editorials credit Fukuda for bucking vested construction interests within his own LDP to offer a proposal for incorporating road-related taxes into general revenue from next year, a key demand of the DPJ and a goal that has long evaded reform-minded elements within the LDP. All of a sudden, Fukuda is being compared favorably in some circles to former Prime Minister Junichiro Koizumi, and DPJ leader Ichiro Ozawa is drawing sharp criticism for choosing short-term political gain over a real opportunity for reform.

¶12. (C) Embassy contacts attribute this shift, in part, to Fukuda's more aggressive use of the media to take his message to the people. They note that the DPJ may have also overplayed the obstructionist card. Polls indicate that voters hold both parties responsible for the Diet gridlock over the tax legislation, but only a quarter of respondents are calling for Fukuda to step down in the near term. Fukuda, for his part, continues to insist that he will not shuffle his Cabinet or dissolve the Lower House before the G-8 Summit in July.

¶13. (C) A bigger problem for Fukuda, Embassy contacts say, will be the fight with the LDP's "road tribe" over the future direction of road-related tax policy. Many LDP members are concerned that he failed to lay the proper groundwork for his proposal before revealing his hand to the DPJ and the public. A related factor is LDP politicians, nationally and at the local and regional level see these funds and the roads they build/maintain as a tool to garner support and votes. He may have support from coalition partner Komeito, which is hinting that it will link support for a two-thirds re-vote on the Special Measures Tax Law to acceptance of Fukuda's ground-breaking proposal to eliminate road construction earmarks. Selling a gas tax rise in the coming weeks to the public will be another difficult chore, with polls showing 60-70 percent of respondents opposed. Fukuda and other ruling party leaders have already noted publicly their

intention to restore the tax. He has tried to justify his position on economic and environmental grounds, noting, for example, that encouraging more people to drive by lowering the price of gas is wrongheaded for a country that is attempting to become a leading environmental power.

SMA Also Lapses; Impact Limited

¶14. (C) Also expiring on March 31, although unrelated to the tax legislation, was the Special Measures Agreement (SMA), governing USD 1.4 billion in host nation support for U.S. Forces in Japan (Ref C). The resulting lapse means that the United States will have to cover funds for labor and utility costs until the bill is passed in early May. Japan is committed to reimbursing those costs. Training relocation exercises will also be suspended during this period.

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¶15. (C) The ruling and opposition parties agreed on March 28 to bring the SMA to a vote in the Lower House plenary on April 4. The bill is certain to clear the Lower House the same day. As an international treaty, the SMA agreement will become law 30 days after passage in the Lower House, regardless of subsequent Upper House action or inaction. The DPJ has yet to decide whether to vote for or against the bill, according to Embassy MOFA contacts, but withdrew its hold on committee action in exchange for an accounting of past use of funds for utilities.

¶16. (C) The opposition fought hard for weeks to delay deliberations on the SMA -- citing the need to discuss the Aegis ship collision and Defense Ministry reform -- before finally taking up formal hearings on March 27. DPJ leaders have criticized elements of the SMA in conversations with Embassy officers and statements to the press, but have never expressed any intention to oppose passage of the measure outright. Embassy contacts expect the Upper House to take a vote on the SMA in mid-April.

SCHIEFFER